

Joint Audit Committee

REGULATORY UPDATE

TO: Chief Financial Officers #12-03
Chief Compliance Officers

DATE: October 18, 2012

SUBJECT: Part 22 of CFTC Regulations – Treatment of Cleared Swaps Customer Collateral – Legally Segregated Operationally Commingled (“LSOC”) Compliance Calculation

In accordance with Part 22 of the CFTC’s Regulations, no later than November 8, 2012 a new regulatory regime for customer cleared swaps takes effect. In the futures markets, for FCM clearing members, Derivatives Clearing Organizations (“DCOs”) are allowed to pool positions and collateral within the commingled FCM omnibus account at the DCO based upon the underlying customers of the FCM. In contrast, for customer cleared swaps, FCM clearing members are required to provide DCOs with information relating to underlying cleared swap customers; that is, positions and collateral value by individual customer. As a result, each DCO must treat the collateral value it receives from an FCM for any cleared swaps customer as belonging to such customer and such amount may not be used to margin, guarantee, or secure other obligations of the FCM or of any other customers.

Therefore, most significantly under the customer cleared swaps rules and regulations, FCMs must:

- Treat and deal with all collateral deposited by a customer to margin its cleared swaps as belonging to such customer, and
- Separately account for and may not commingle such collateral with its own property and may not use such collateral to margin the cleared swaps of any person other than the customer depositing such collateral.

Thus, under the new rules, FCMs must hold such cleared swaps customer collateral in an account that is separate from the property belonging to the FCM and separate from collateral of futures and foreign futures and options customers, and must not use the collateral of one cleared swaps customer to cover the obligations of another cleared swaps customer or the obligations of the FCM.

To implement the new regulations, FCMs will need to compute a Statement of Cleared Swaps Customer Requirements and Funds in Cleared Swaps Customer Accounts (“Cleared Swaps Customer Statement”) and a LSOC Compliance Calculation as detailed below.

Cleared Swaps Customer Statement

Similar to a customer segregation statement required for futures trading activity under Section 4d(a) of the Commodity Exchange Act, FCMs will be required to compute daily, on a currency by currency basis, a Cleared Swaps Customer Statement. The Cleared Swaps Customer Statement must be completed by 12:00 noon on the following business day. The Cleared Swaps Customer Statement is attached to this JAC Regulatory Update.

Further, in accordance with applicable exchange and self-regulatory organization ("SRO") rules, the daily Cleared Swaps Customer Statement must be filed through WinJammer™ by 12:00 noon on the following business day. These daily statements must be electronically submitted and signed off by the FCM's Chief Executive Officer, Chief Financial Officer or their designated representative as allowed under SRO requirements.

The Cleared Swaps Customer Statement should reflect:

- The Cleared Swaps Customer Requirement as defined in CFTC Regulation 22.2(f)(4) which, in essence, represents the FCM's liability to its cleared swaps customers maintaining credit balances; that is, the Net Liquidating Method as used to compute the segregation requirement for futures trading under Section 4d(a) of the Commodity Exchange Act.
- The aggregate market value of Funds in Cleared Swaps Customer Accounts held at acceptable locations as set forth in CFTC Regulations 22.2(b), 22.4 and 22.9. Further to be included in the statement, such cleared swaps customer funds held at permitted depositories must be held in an account properly titled as a "Cleared Swaps Customer Account" and covered by a satisfactory acknowledgement letter. In addition, FCM investments of cleared swaps customer funds must be in compliance with CFTC Regulation 1.25 as incorporated by CFTC Regulation 22.2(e)(1).
- The amount of the FCM's residual interest in such Cleared Swaps Customer Accounts; that is, firm excess cleared swaps customer funds.

LSOC Compliance Calculation

As detailed in CFTC Regulation 22.2(d), "No futures commission merchant shall use, or permit the use of, the Cleared Swaps Customer Collateral of one Cleared Swaps Customer to purchase, margin, or settle the Cleared Swaps or any other trade or contract of, or to secure or extend the credit of, any person other than such Cleared Swaps Customer. Cleared Swaps Customer Collateral shall not be used to margin, guarantee, or secure trades or contracts of the entity constituting a Cleared Swaps Customer other than in Cleared Swaps, except to the extent permitted by a Commission rule, regulation or order."

Further CFTC Regulation 22.15 provides, "Subject to §22.3(d) of this part, each derivatives clearing organization and each Collecting Futures Commission Merchant receiving Cleared Swaps Customer Collateral from a futures commission merchant shall treat the value of collateral required with respect to the portfolio of rights and obligations arising out of the Cleared Swaps intermediated for each Cleared Swaps Customer, and collected from the futures commission merchant, as belonging to such customer, and such amount shall not be used to margin, guarantee, or secure the Cleared Swaps or other obligations of the futures commission merchant or of any other Cleared Swaps Customer or Customer. Nothing contained herein shall be construed to limit, in any way, the right of a derivatives clearing organization or Collecting Futures Commission Merchant to liquidate any or all positions in a Cleared Swaps Customer Account in the event of default of a clearing member or Depositing Futures Commission Merchant."

As a result, each DCO will call for the gross initial margin deficiencies of each cleared swaps customer based upon the customer's cleared swaps positions and reported collateral value.¹ DCOs will, however, continue to calculate and call for variation margin on a net basis.²

Therefore each FCM must ensure it has contributed enough of its own funds to the cleared swaps customer account to cover the aggregated gross margin deficiencies of all cleared swaps customers, in effect ensuring that the excess collateral of one cleared swaps customer is not used to margin the positions of another cleared swaps customer. This determination should be made prior to any end-of-day and intra-day payment cycle of initial and/or variation margin by an FCM to a DCO.^{3,4}

To ensure compliance with such regulations, an FCM must determine (1) the margin status of each cleared swaps customer account and the resulting overall LSOC margin deficiency; (2) the amount of firm contributed assets to the cleared swaps account class; and (3) the amount, if any, to be deposited into the cleared swaps customer account to cover the LSOC margin deficiency.

Cleared Swaps Customer Account Margin Status and LSOC Margin Deficiency

In determining the margin status for each cleared swaps customer, all their cleared swaps collateral and positions (aggregated across all currencies and DCOs) are included. For each cleared swaps customer account the margin status is calculated as:

Margin Equity:

Ledger Balance⁵ + Open Trade Equity⁵ + Net Option Value + Collateral Value of Acceptable Margin Deposits⁶

¹ Note in the first phase of LSOC implementation, DCOs will utilize an unallocated excess mode and will issue a margin call for the sum of the gross client-specific initial margin increases. Further, during the first phase of LSOC implementation, FCMs will not be required to submit the collateral value for each cleared swaps customer.

² Note that the treatment of variation margin post default will be based on the rules of the applicable DCO.

³ For clarity, at the end of each day, an FCM should complete its LSOC Compliance Calculation prior to the first end-of-day settlement payment (occurring on the following business day). Such calculation will be the basis for all end-of-day payments unless an intra-day or special call is made by a DCO before an end-of-day payment is made. In such case, the LSOC Compliance Calculation will need to be updated for the intra-day/special call along with any collateral settlements made with any cleared swaps customers as well as FCM funds contributed or withdrawn from cleared swaps customer depositories. Likewise the LSOC Compliance Calculation will need to be updated prior to any intra-day call in the same manner.

⁴ Likewise, an FCM must ensure it has contributed enough of its own funds to cover such gross margin deficiencies before making payment of initial margin to a Collecting FCM as defined under CFTC Regulation 22.1.

⁵ Ledger balance and open trade equity shall include cash and all other realized and unrealized components of variation margin including upfront fees/reset to par, initial coupon, accrued coupon, price alignment interest ("PAI") and mark-to-market amounts.

⁶ The collateral value of acceptable margin deposits may not exceed market value less applicable haircuts as set forth in SEC Rule 240.15c3-1.

Margin Excess or Deficiency:

Margin Equity – DCO Minimum Margin Requirement^{*7}

* If positive Margin Excess; if negative Margin Deficiency

LSOC Margin Deficiency:

The LSOC margin deficiency is the aggregate of all margin deficiencies of the FCM's cleared swaps customers. That is the gross total of all margin deficiencies of cleared swaps customers.

Firm Contributed Assets

The amount of firm contributed assets is equal to:

Total amount in cleared swaps customer accounts (Cleared Swaps Customer Statement Line 13) – Net equity of cleared swaps customers (Cleared Swaps Customer Statement Line 4).

LSOC Compliance

In compliance with CFTC regulations, firm contributed assets should exceed the LSOC margin deficiency so that the collateral of one cleared swaps customer is not used to cover the obligations of another cleared swaps customer.

If an FCM does not hold enough firm contributed assets to cover the LSOC margin deficiency, then the firm must deposit additional FCM funds into an acceptable cleared swaps customer account to meet the shortfall before payment is made to any DCO.⁴ The deposit of additional funds into cleared swaps customer accounts must be made in accordance with CFTC Regulation 1.25.⁸ For clarity, there is no violation of CFTC regulations or notice requirements if the LSOC Compliance Calculation reflects a shortfall in firm contributed assets to cover the LSOC margin deficiency provided the FCM deposits additional funds to meet the shortfall before payment is made to any DCO. However, if an FCM does not deposit sufficient funds to meet the shortfall before payment is made to any DCO, the FCM must immediately notify its DSRO and the CFTC through WinJammer and take immediate corrective action.

⁷ If the FCM clears through another FCM, defined as a Collecting FCM, then the minimum margin requirement is that required and collected by the Collecting FCM.

⁸ Solely for purposes of meeting the LSOC margin deficiency with a deposit of additional funds into a cleared swaps customer account prior to payment to any DCO, the requirements of CFTC Regulation 1.49 with respect to denomination or jurisdiction will not apply. However, the FCM must comply with CFTC Regulation 1.49 in computing its Cleared Swaps Customer Account Statement at all times. It is only with respect to the top up for the LSOC margin deficiency that the requirements of denomination and jurisdiction of CFTC Regulation 1.49 are not applicable. Those requirements remain fully applicable with respect to the Cleared Swaps Customer Requirement. The additional deposit required for the LSOC margin deficiency should only represent additional firm excess funds held in cleared swaps customer accounts.

As such, FCMs may meet a LSOC margin deficiency overnight with an additional deposit before the morning DCO payments without regards to CFTC Regulation 1.49 restrictions on denomination and jurisdiction. Any funds deposited to meet the LSOC margin deficiency not in compliance with CFTC Regulation 1.49 should be replaced in order to be considered as good funds in cleared swaps customer accounts.

Notwithstanding the foregoing, in no event shall an FCM hold customer funds in a restricted country subject to sanctions by the Office of Foreign Assets Control of the U.S. Department of Treasury.

FCMs must maintain records of their LSOC Compliance Calculations along with evidence of any deposit of additional funds, if required, before payment is made to any DCO.⁴

It is important to note that the Cleared Swaps Customer Statement and LSOC Compliance Calculation are separate calculations and each must reflect compliance with their respective CFTC Regulations.

For reference, CFTC's Final Part 22 Regulations were published in the Federal Register (February 7, 2012, Vol. 77, No. 25, at page 6336) and can be found on the CFTC's web site at <http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2012-1033.html>. The regulations themselves can be found on <http://ecfr.gpoaccess.gov/> at <http://www.ecfr.gov/cgi-bin/text-idx?c=ecfr&SID=8570ff22ae85094d95994b0ee2df6728&rqn=div5&view=text&node=17:1.0.1.1.21&idno=17>.

While Part 22 of the CFTC's Regulations provide that no later than November 8, 2012 a new regulatory regime for customer cleared swaps takes effect, CME, ICE Clear Credit and LCH.Clearnet will implement LSOC for cleared swaps customers effective November 5, 2012.

If you have any questions, please contact your DSRO.

STATEMENT OF CLEARED SWAPS CUSTOMER REQUIREMENTS AND FUNDS IN CLEARED SWAPS CUSTOMER ACCOUNTS

Cleared Swaps Customer Requirements

1 Net ledger balance			
A. Cash		\$0	8500
B. Securities (at market)		0	8510
2 Net unrealized profit (loss) in open cleared swaps		0	8520
3 Cleared swaps options			
A. Market value of open cleared swaps option contracts purchased		0	8530
B. Market value of open cleared swaps option contracts granted (sold)		0	8540
4 Net equity (deficit)		\$0	8550
5 Accounts liquidating to a deficit and accounts with debit balances - gross amount	\$0	8560	
Less: amount offset by customer owned securities	0	8570	0 8580
6 Amount required to be separately held for cleared swaps customers (add lines 4 and 5)		\$0	8590

Funds in Cleared Swaps Customer Accounts

7 Deposited in cleared swaps customer accounts at banks			
A. Cash		\$0	8600
B. Securities representing investment of customers' funds (at market)		0	8610
C. Securities held for particular customers or option customers in lieu of cash (at market)		0	8620
8 Margins on deposit with derivatives clearing organizations in cleared swaps customer accounts			
A. Cash		0	8630
B. Securities representing investment of customers' funds (at market)		0	8640
C. Securities held for particular customers or option customers in lieu of cash (at market)		0	8650
9 Net settlement from (to) derivatives clearing organizations			0 8660
10 Cleared swaps options			
A. Value of open cleared swaps long option contracts		0	8670
B. Value of open cleared swaps short option contracts		0	8680
11 Net equities with other FCMs			
A. Net liquidating equity		0	8690
B. Securities representing investment of customers' funds (at market)		0	8700
C. Securities held for particular customers or option customers in lieu of cash (at market)		0	8710
12 Cleared swaps customer funds on hand			0 8715
13 Total amount in cleared swaps customer accounts (add lines 7 through 12)		\$0	8720
14 Excess (deficiency) funds in cleared swaps customer accounts (subtract line 6 from line 13)		\$0	8730